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The North Carolina Banking Institute Symposium on the Foreclosure Crisis: The Unintended and Unconstitutional Consequences of the Helping Families Save Their Homes Act

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I. INTRODUCTION

"At the end of 2008, more than one in ten homeowners were either past due or in foreclosure."[1] Economists project "one in every nine homeowners . . . will lose their home to foreclosure" by the end of 2012.[2] Meaning that "8.1 million households . . . [will be in] foreclosure."[3] Because of the falling housing market and high numbers of foreclosures that have adversely affected our national economy, Congress has enacted legislation to curb foreclosures.[4]

The Helping Families Save Their Homes Act[5] (HFSTH) authorizes home loan servicers to modify mortgages in foreclosure so that homeowners can continue to make mortgage payments and avoid foreclosure.[6] HFSTH attempts to encourage modifications by providing incentives to loan servicers to modify mortgages and a servicer safe harbor provision to protect servicers from investor

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1. Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 567 (2009); *see also id.* at 565 (testing the assumption that "protecting lenders from losses . . . encourages them to lend more and at lower rates").

2. *Id.* at 567.

3. Dana Heller, *Understanding the Economic Complexities of Loan Modification Programs*, NERA ECONOMIC CONSULTING, Feb. 25, 2009, at 2, http://www.nera.com/image/PUB_Loan_Modification_Program_0209.pdf.

4. *See* Press Release, Sec'y Henry M. Paulson, Jr., U.S. Dep't of the Treasury, Statement on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), http://www.ustres.gov/press/releases/hp1129.htm [hereinafter Paulson Jr. Statement].

5. Helping Families Save Their Homes Act, Pub. L. No. 111-22, 123 Stat. 1632 (2009) (codified as amended in scattered sections of U.S.C.).

6. Helping Families Save Their Homes Act § 201(codified as amended at 15 U.S.C. § 1639a); *see also* Editorial, *Hurting the Housing Market; Obama's Policies Drive Down Prices*, WASH. TIMES, May 29, 2009, at A20, *available at* http://www.washingtontimes.com/news/2009/may/29/hurting-the-housing-market/ (discussing the recent drop in housing prices and the legislation that may have caused the drop).

litigation arising from a servicer's modification of mortgages in the loan pool.[7]

Many members of the public are pleased with the inclusion of the safe harbor provision in the Act.[8] They believe that the Act will change servicers' traditional roles and encourage modifications.[9] Nevertheless, some consumer advocates believe that the Act was weakened due to political pressure from banking industry actors who oppose bankruptcy procedure changes.[10] Another author in this symposium, Marjorie B. Maynard, argues that the Act will not be effective unless homeowners can force a cramdown in Chapter Thirteen bankruptcy.[11] Although the Act's safe harbor is politically popular and may not be effective, its opponents note that the possible implications of the provision were not thoroughly examined and argue that this hasty legislation violates the Fifth Amendment's property protections.[12]

Unfortunately, because the Act was only recently passed, commentators can only speculate whether Congress will enact tougher provisions or if the legislative efforts will be struck down as unconstitutional.[13] *Greenwich Financial Services, et al. v.*

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7. Helping Families Save Their Homes Act § 201(b), 123 stat. 1638 (codified as amended at 15 U.S.C. § 1639a); *see also* Press Release, House Comm. on Fin. Services, Judiciary and Fin. Services Comm. Joint Hous. Bill Introduced in the House (Feb. 23, 2009) (describing the benefits to servicers provided by HFSTH).

8. *See* Press Release, Washington State Dep't of Fin. Inst. DFI Applauds The FHA's Efforts to Assist Homeowners Facing Foreclosure in Obtaining Loan Modifications (Aug. 5, 2009), http://www.dfi.wa.gov/consumers/news/2009/fha.htm

9. *Id.*

10. *See* Margie Burns, *Senate Caves to Bankers, Passes up Chance to Help U.S. Homeowners*, ATLANTIC FREE PRESS, (May 31, 2009), http://www.atlanticfreepress.com/news/1/9836-senate-caves-to-bankers-passes-up-chance-to-help-us-home owners.html.

11. Marjorie B. Maynard, Note, *Mortgage Cramdown in Bankruptcy: A Necessary Incentive to Encourage Mortgage Modifications*, 14 N.C. BANKING INST. 275 (2010).

12. *See* Complaint at 12, Greenwich Fin. Serv. Distressed Mortgage Fund 3, LLC v. Countrywide Fin. Corp., N.Y. Sup. Ct. Pleadings 58147 (2008), *available at* 2008 NY S. Ct. Pleadings LEXIS 77 (explaining that the PSA agreed to by the parties requires Countrywide to repurchase modified loans); *see also* Isaac Gradman, *Why Should Servicers Get a Safe Harbor? How One Investor's Lawsuit Forced Bank of America to Seek Shelter in Washington*, LOMBARD STREET, Aug. 3, 2009, http://www.finreg21.com/lombard-street/why-should-servicers-get-a-safe-harbor-how-one-investor%E2%80%99s-lawsuit-forced-bank-america (discussing the economic impact of the litigation safeharbor on the MBS investors).

13. Gradman, *supra* note 12; Christopher Mayer et al., *A New Proposal for Loan Modifications*, 26 YALE J. ON REG. 417, 417-28 (2009) (proposing solutions to

Countrywide Financial Corp., et al., a recent case being heard in New York state court, may provide an answer to how courts will decide if the Act's safe harbor is constitutional.[14] Until *Greenwich Financial* is decided, the safe harbor's constitutionality will continue to be debated in academic legal writing.[15] Some commentators have proposed an alternative solution that would not result in a constitutional violation.[16] Based on *Penn Central Transportation Co. v. New York City*,[17] *Lucas v. South Carolina Coastal Council*,[18] *Loretto v. Teleprompter Manhattan CATV Corp.*,[19] and *Nollan v. California Coastal Commission*,[20] however, the HFSTH's litigation safe harbor provision for mortgage servicers unconstitutionally deprives investors of their property rights under the Fifth and Fourteenth Amendments.[21]

"barriers" to "successful loan modifications"); Gretchen Morgenson, *Countrywide Loses Ruling in Loan Suit*, N.Y. TIMES, Aug. 20, 2009 at B1, *available at* http://www.nytimes.com/2009/08/20/business/20bofa.html.

14. *See* Complaint, *supra* note 12; Motion to Remand, Greenwich Fin. Serv. Distressed Mortgage Fund 3, LLC v. Countrywide Fin. Corp., U.S. Dist. Ct. Motions 11343 (2008), *available at* 2009 U.S. Dist. Ct. Motions LEXIS 18208. The case was remanded from the Southern District of New York back to state court for lack of subject matter jurisdiction. Greenwich Fin. Serv. Distressed Mortgage Fund 3, LLC v. Countrywide Fin. Corp., 654 F. Supp. 2d 192 (2009).

15. *See* Gradman, *supra* note 12, at Part III.

16. *See* Mayer et al., *supra* note 13.

17. Penn Central Transp. Co. v. New York City, 438 U.S. 104 (1978) (displaying the three factors analyzed to determine whether a non-physical, regulatory taking has occurred that requires compensation).

18. Lucas v. S.C. Coastal Council, 505 U.S. 1003 (1992) (showing that compensation is required where government action leaves an individual's property economically valueless).

19. Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982) (outlining that a permanent physical intrusion by government, no matter now small, requires compensation).

20. Nollan v. Cal. Coastal Comm'n, 483 U.S. 825 (1987) (discussing the requirement that government action must advance a substantial state interest to avoid being a taking requiring compensation).

21. *See Lucas*, 505 U.S. at 1027-32 ("In the case of land . . . we think the notion pressed by the Council that title is somehow held subject to the "implied limitation" that the State may subsequently eliminate all economically valuable use is inconsistent with the historical compact recorded in the Takings Clause that has become part of our constitutional culture."); *Nollan*, 483 U.S. at 841-42 ("our cases describe the condition for abridgment of property rights through the police power as a '*substantial* advanc[ing]' of a legitimate state interest."); *Loretto*, 458 U.S. at 441 ("We affirm the traditional rule that a permanent physical occupation of property is a taking. In such a case, the property owner entertains a historically rooted expectation of compensation, and the character of the invasion is qualitatively more intrusive than perhaps any other category of property regulation."); *Penn Central* 438 U.S. at

To support this argument Part II will discuss the safe harbor provision in detail, how it has been interpreted and received by various groups, and how it evolved into its current statutory form.[22] Part III will give a brief overview of Takings Clause precedent and will analyze the safe harbor's constitutionality based on that precedent.[23] Part IV will demonstrate the power of the safe harbor provision by showing how investor rights have been compromised and how servicers may be able to benefit under the new scheme.[24] Finally, Part V will discuss alternatives to the litigation safe harbor and suggestions on how Congress's intentions might be better met and how individual's rights can be better protected by improving refinancing options.[25]

II. A CLOSER LOOK AT THE LITIGATION SAFE HARBOR

A. Factors Influencing the Development of the Safe Harbor

At a hearing before the Senate Banking Committee in July 2009, individuals who represent the key players in the housing market attempted to provide some insight about methods that would help preserve homeownership.[26] At this hearing, the representatives explained the systemic problems that impede mortgage modifications.[27] Curtis Glovier, Managing Director of Fortress Investment Group, blamed the treatment of second liens in bankruptcy accounting as a factor that makes lenders and

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136-38 ("inquiry may be narrowed to the question of the severity of the impact of the law on appellants' parcel")

22. *See infra* Part II, pp. 240-44.

23. *See infra* Part III, pp. 244-51.

24. *See infra* Part IV, pp. 251-53.

25. *See infra* Part V, pp. 235-56.

26. *See generally Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the S. Banking, Housing, & Urban Affairs Comm.*, 111th Cong. (2009) (testimony of Curtis Glovier, Managing Director, Fortress Investment Group) [hereinafter *Glovier Testimony*]; *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the S. Banking, Housing, & Urban Affairs Comm.*, 111th Cong. (2009) (testimony of William Apgar, Senior Advisor to the Secretary for Mortgage Finance, U.S. Dept. of Housing and Urban Development) [hereinafter *Apgar Testimony*].

27. *See Apgar Testimony, supra* note 26

investors unwilling to participate.[28] He explained that under the program, banks that offered second mortgages and their affiliated servicers, who are aware that the second lien is subordinate to the primary lien, are "unwilling to . . . complete a refinance" because it would "defer the recognition of losses on the second lien portfolios."[29] HUD's Senior Advisor for Mortgage Finance, William Apgar, stated that the reluctance to participate in the programs is a result of the lack of incentives for lenders and servicers.[30]

Outside of Congressional hearings, academics have also discussed the problem of uninterested servicers.[31] Dr. Dana Heller, Vice President of NERA Economic Consulting and former Professor of Financial Services at Tel Aviv University, stated that the unwillingness of servicers to modify loans in foreclosure is a result of covenants in their PSAs with investors that create a "litigation risk" for them.[32] Some PSAs give "limited (or no) authority to the servicer to modify loans," so participation in the Making Home Affordable program would be a breach of contract giving investors a chance to bring suit.[33] Because the fear of investor litigation was one of the significant factors hindering modification, academics suggested a safe harbor that would protect the servicers from the investors.[34]

B. The Servicer Litigation Safe Harbor

Section 201 of HFSTH states that "[i]n order to reduce the number of foreclosures and to stabilize property values, local economies, and the national economy, servicers must be given . . . (A) authorization to . . . modify . . . and refinance mortgage loans . . . and (B) a safe harbor to enable such servicers to exercise these

28. *See Glovier Testimony*, *supra* note 26.
29. *See id.*
30. *See id.*
31. *See* Heller, *supra* note 3, at 8.
32. *Id.* at 9.
33. *Id.*
34. Mayer et al., *supra* note 13, at 422-23.

authorities."[35] The section amends the Truth in Lending Act to provide that:

> [A] servicer that is deemed to be acting in the best interests of all investors or other parties . . .and shall not be liable to any party who is owed a duty . . .and shall not be subject to any injunction, stay, or other equitable relief to such party, based solely upon the implementation by the servicer of a qualified loss mitigation plan.[36]

The section also defines "qualified loss mitigation plan" as:

> (A) a residential loan modification, workout, or other loss mitigation plan, including to the extent that the Secretary of the Treasury determines appropriate, a loan sale, real property disposition, trial modification, pre-foreclosure sale, and deed in lieu of foreclosure, that is described or authorized in guidelines issued by the Secretary of the Treasury or his designee under the Emergency Economic Stabilization Act of 2008; and
> (B) a refinancing of a mortgage under the Hope for Homeowners program.[37]

The language of the statute gives the servicer broad authority to determine what action can be taken to mitigate loss but the section resticts when a loss mitigation plans may be used.[38] HFSTH requires that before entering into a qualified loss mitigation plan: (1) the servicer must believe that "[d]efault on payment of such mortgage has occurred, is imminent, or is reasonably foreseeable," (2) "[t]he mortgagor occupies the property securing the mortgage[,]" and (3) "[t]he servicer

35. Helping Families Save Their Homes Act, Pub. L. No. 111-22, §201, 123 Stat. 1638 (2009) (codified as amended at 15 U.S.C. § 1639a).

36. *Id.*

37. *Id.*

38. *Id.*

reasonably determined . . .that the application of such qualified loss, mitigation plan . . . will likely provide an anticipated recovery on the outstanding principal mortgage debt that will exceed the anticipated recovery through foreclosures."[39] Although the language of the provision seems to be clear about the breadth of the safe harbor, there is much debate as to how much protection the safe harbor will provide.[40]

The last subsection of section 201, the "Rule of Construction Clause," provides that the safe harbor will not affect a party's right to bring suit under certain circumstances.[41] It explicitly states that

> No provision. . .shall be construed as affecting the liability of any servicer or person. . .for actual fraud in the origination or servicing of a loan or in the implementation of a qualified loss mitigation plan, or for the violation of a State or Federal law, including laws regulating the origination of mortgage loans, commonly referred to as predatory lending laws.[42]

Although some of the statute's provisions seem to shield servicers from all things short of illegal acts, this final subsection means it will not protect servicers when they act unlawfully.[43] Investors also believe they may have found two loopholes that will allow suit outside of a violation of predatory lending laws.

The ABS Investor Advocate concluded after analyzing the "Scope of the Safe Harbor" clause that the inclusion of the word "solely" allows investors to bring suit "[i]f [they] can find any other basis for liability-either a violation of a statute or even a breach of any provision of the PSA (other than provisions that prohibit

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39. *Id.*

40. *See* Owen Cyrulnik, *How Safe is the Harbor?*, ABS INVESTOR ADVOCATE, May 22, 2009, http://www.absinvestoradvocate.com/2009/05/articles/servicer-safe-harbor-1/how-safe-is-the-harbor/ (last visited Sept. 23, 2009) [hereinafter Cyrulnik, *How Safe*].

41. Helping Families Save Their Homes Act, § 201.

42. *Id.*

43. *See id*; Cyrulnik, *How Safe*, *supra* note 40.

modification)."[44] The second potential loophole is the interpretation of the "Rule of Construction Clause."[45] Commentators have interpreted the Clause to mean that "some classes of investors may be able to assert a claim in instances when an express contractual provision in the applicable pooling and servicing agreement . . . expressly prohibits the suggested modification."[46] To date, no courts have ruled on the interpretation of these clauses.

III. CHALLENGES TO THE SERVICER LITIGATION SAFE HARBOR

A. Analysis of the Language

When discussing the strength of the safe harbor provision, a commentator observed that "when we want to build a road and we take somebody's land for the public good, we compensate them. If you want to take somebody's mortgage rights for the public good, you compensate them."[47] Both supporters and opponents of the safe harbor provision have recognized that there may be a violation of the Fifth Amendment's Takings Clause.[48] The Fifth Amendment states:

> No person shall. . .be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.[49]

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44. Cyrulnik, *How* Safe, *supra* note 40.

45. *Id.*

46. *Financial Crisis Special Situations Group Client Alerts: Helping Families Save Their Homes Act of 2009*, SONNENSCHEIN PUBLICATIONS (Sonnenschein Nath & Rosenthal, LLP), May 29, 2009, http://www.sonnenschein.com/practice_areas/financial_crisis/pub_detail.aspx?id=51668&type=E-Alerts (May 29, 2009)

47. *Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. 16 (2009) (statement of Mark A. Calabria, PH.D., Director of Financial Regulatory Studies, Cato Institute).

48. Gradman, *supra* note 12, at Part V; Mayer et al, *supra* note 13, at 424.

49. U.S. CONST. amend. V.

The Supreme Court has continued to hold that "the 'Fifth Amendment's guarantee . . . [is] designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole[.]"[50] When determining whether a taking requiring compensation has occurred, the court first looks to the nature of the taking.[51]

B. The Constitutionality of the Provision

1. Case Law Analysis and Interpretation

Traditionally, the court has recognized two types of takings that could require compensation: physical takings[52] and regulatory takings.[53] In the case of physical takings, the court has stated that "permanent physical occupation authorized by government is a taking without regard to the public interests that it may serve" and that government may "never deny compensation for a physical takeover."[54] All courts considering this issue have reached this conclusion because "the right to exclude [others is] 'one of the most essential sticks in the bundle of rights that are commonly characterized as property.'"[55] For regulatory takings, the court has applied a balancing test to determine the impact that the regulation has had on the property owner to see how similar it is to a physical taking.[56] If the regulation strips the property of all

50. Penn Central Transp. Co. v. New York City, 438 U.S. 104, 123 (1978) (quoting Armstrong v. U.S., 364 U.S. 40, 49 (1960)). The Court qualifies this statement in *Penn Central* by stating "this Court, quite simply, has been unable to develop any 'set formula' for determining when 'justice and fairness' required that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons." *Id.* at 124

51. *See* Lucas v. S.C. Coastal Council, 505 U.S. 1003, at 1014 (1992).

52. Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982) (showing that regulatory takings can be physical in nature).

53. *See* Lucas, 505 U.S. 1003 (1992) (proving that although a taking can be purely regulatory in nature, the effect on the property may be such that it requires compensation); Nollan v. Cal. Comm'n, 483 U.S. 825 (1987) (requiring that regulatory takings substantially advance a legitimate state interest to avoid payment to the affected property owner); Penn Central, 438 U.S. 104 (1978) (establishing a balancing test for purely regulatory takings).

54. Loretto, 458 U.S. at 426-27 (citation omitted).

55. *Id.* at 433 (quoting Kaiser Aetna v. United States. 444 U.S. 164, 176 (1979)).

56. Lucas, 505 U.S. at 1015-16.

economic value,[57] or has had a significant economic impact on the owner and has interfered greatly with investment-backed expectations, the court has also agreed to recognize a taking requiring compensation.

Four major cases lay out how the court has handled various government actions under the Takings Clause regulatory analysis. First, in *Penn Central*, the Court determined that the New York City landmark law did not "arbitrarily" deprive the plaintiffs of their property even though it would not allow them to reconstruct their building to expand their business.[58] The case established an "ad hoc analysis" of three factors: (1) the "economic impact of the regulation," (2) the "extent to which the regulation has interfered with distinct investment-backed expectations," and (3) the "character" of the governmental action.[59] Although the Court did not clarify the required strength of each of the factors, it did base the *Penn Central* decision almost solely on the "economic impact" factor.[60] Justice Brennan explained that the regulation did not prohibit the plaintiffs from using the property in the same manner that they had been previously and that some government actions can be "viewed as permissible. . .even when prohibiting the most beneficial use of the property."[61]

The remaining cases limited the application of *Penn Central* or provided guidance on how to use its balancing test. In *Loretto*, the court ruled the New York statute requiring property owners to allow a cable company to install cable boxes on their property and prohibiting them from collecting payment from tenants for cable usage was unconstitutional.[62] In striking down the statute, the court reasoned that regulatory takings can take the form of a "physical intrusion by government" akin to traditional physical takings and render the balancing test irrelevant.[63] The New York statute allowed for a complete physical takeover of the space

57. *Id.* at 1027-31 (articulating the "economic value" standard); Penn Central, 438 U.S. at 124 (stating the "investment backed expectations" standard).

58. Penn Central, 438 U.S. at 132

59. *Id.* at 124.

60. *Id.*

61. *Id.* at 125.

62. Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982).

63. *Id.* at 426.

containing the cable box because the property owner no longer had the power to "posses use [or] dispose of it" and was therefore unconstitutional.[64] Accordingly, the Court will not engage in a *Penn Central* balancing analysis where a statute is too close to a "physical intrusion by government."

In *Nollan v. California Coastal Commission*, the court applied the balancing test to the California Coastal Commission's conditional building permit and held that the permit did not "substantially advance a legitimate state interest."[65] Justice Scalia explained that for a government action to be permissible there must be an "essential nexus" between the action taken and the public interest to be protected.[66] As a part of the regulatory balancing test, the court reasoned that for a regulatory taking to be permissible, the action taken must advance a substantial state interest.[67] The court did not allow the action taken because the conditional permit did not prevent the stated goal of preventing the development of a "wall of houses."[68]

Finally, in *Lucas v. South Carolina*, the court recognized another form of regulatory taking where the government action renders the property economically "valueless."[69] In *Lucas*, the South Carolina Coast Commission re-zoned Lucas' parcels of land and prohibited him from building on the land.[70] The Court found that "when the owner of real property has been called upon to sacrifice *all* economically beneficial uses in the name of the common good, that is, to leave his property economically idle, he has suffered a taking."[71] To clarify the reach of *Lucas* the court stated that compensation is due where there is a "total deprivation of use."[72]

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64. *Id.* (citing United States v. General Motors Corp., 323 U.S. 373, 378 (1945)).

65. Nollan v. Cal. Coastal Comm'n, 483 U.S. 825, 834-40 (1987) (quoting Agins v. Tiburon, 447 U.S. 255, 260 (1980)).

66. *Id.* at 837.

67. *Id.* at 834.

68. *Id.* at 840.

69. Lucas v. S.C. Coastal, 505 U.S. 1003 (1992); Steven J. Eagle, Regulatory Takings § 7-3(a)(1) (3d. ed. 2005). Eagle, *supra* note 103 at § 7-3(a)(1).

70. *Id.* at 1007

71. *Id.* at 1019.

72. Eagle, *supra* note 69 at § 7-3(a)(1).

Although *Loretto* and *Lucas* are not directly on point, MBS investors can argue that the safe harbor provision results in a Takings Clause violation citing *Penn Central* and *Nollan*.[73] Although *Penn Central* is vague, it gives great guidance to investors.

The nature of the dispute between investors, servicers, and the federal government leads us to the *Penn Central* test. MBS investors are angered by the safe harbor because it prevents the investors from enforcing contracts requiring servicers to either repurchase loans or foreclose so that they might receive the highest return on their investment.[74] Unlike later takings cases that narrowed the scope of the balancing test, *Penn Central* did not involve a physical invasion of property[75] nor a complete deprivation of economic benefit.[76] In applying the *Penn Central* test, we first look to the economic impact of the regulation.[77] It can be argued that the economic impact of the safe harbor can be devastating.[78] The safe harbor provision has cost blameless investors billions of dollars,[79] and, depending on the size of the investment, could significantly affect the investors' financial stability.[80] Next, we should look to the extent the regulation has interfered with the investors' investment-backed expectations.[81] The expectations of investors are directly adverse to the safe harbor provision of the Act.[82] Investors expected that the covenants that they entered into with loan servicers would be

73. *Loretto* is not on point for MSB investors because no physical taking has occurred. *Lucas* is not controlling because there has not been a complete deprivation of economic use, and because investors will be able to receive some money from modifications. Since MBS investors will receive some money, they cannot claim that the securities have lost all economic value.

74. Morgenson, *supra* note 13.

75. Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419

76. Lucas v. S.C. Coastal Council, 505 U.S. 1003 (1992).

77. Penn Central Transp. Co. v. New York City, 438 U.S. 104 (1978).

78. David J. Grais, *Five Reasons Why "Servicer Safe Harbor'Will be Bad for America*, ABS INVESTOR ADVOCATE, May 18, 2009, http://www.absinvestorad vocate.com/2009/05/articles/servicer-safe-harbor-1/five-reasons-why-servicer-safe-harbor-will-be-bad-for-america/ (last visited Jan. 20, 2010).

79. *See* Complaint, *supra* note 12, at 11.

80. *See Glovier Testimony, supra* note 26.

81. Penn Central, 438 U.S. at 124.

82. Grais, *supra* note 78.

enforceable by the courts but the safe harbor provision interferes so much with their expectations that it may nullify provisions in their PSAs and subjects them to an investment scheme that they would not have entered into initially.[83] Finally, the test requires consideration of the "character of the governmental action."[84] Although "a taking may more readily be found when the interference with property can be characterized as a physical invasion," the Court does not state explicitly or implicitly that the action taken must be a physical invasion for the plaintiff to be able to prove a taking has occurred.[85] Unfortunately the lack of clarity on the relative weight of each *Penn Central* factor makes succeeding under the test difficult.[86] The vagueness of the test also requires that we wait for directly analogous litigation.[87]

Relying on *Nollan*, the MBS investors can argue that the relationship between the safe harbor and the HFSTH's goal is weak. The administration claims that the Act and the safe harbor provision will improve the housing market,[88] while investors claim that this safe harbor will ultimately harm the housing market.[89] Investor advocates state that the housing market will be negatively affected by the safe harbor provision because investors will be less likely to provide the funds necessary for banks to lend for mortgages because they will not have legal recourse to protect their interests.[90] Because *Nollan* requires a finding of an "essential nexus," investors can show that the safe harbor provision does not

83. *Id.*

84. Penn Central, 438 U.S. at 124.

85. *Id.* at 124.

86. *See generally* Eagle, *supra* note 69 at § 7-7(b)(2) (stating that the test prohibits compensation where it is shown that the parcel is "capable of producing a reasonable return" while claiming that it is reasonable for a flagship store to situate themselves in a commercial development where it cannot sustain itself so that surrounding stores can thrive because of its presence).

87. *See* Gradman, *supra* note 12, at Part V ("Yet, the question of how the dozen words of the Clause and this stated purpose apply to particular government action has engendered a mountain of impenetrable Supreme Court precedent that makes it next to impossible to predict what regulations the Court will find go 'too far.'").

88. Helping Families Save Their Homes Act, Pub. L. No. 111-22, §201, 123 stat. 1638 (2009) (codified as amended at 15 U.S.C. § 1639(a)).

89. Grais, *supra* note 78.

90. *Id.*

achieve the goals that the government set and that the taking is unjustified.

2. Congressional Concern with the Safe Harbor as a Taking

In February 2009, the House passed H.R. 1106.[91] The language of its safe harbor provision differed greatly from the final version of the provision as amended in the Senate.[92] The safe harbor in H.R. 1106 would protect servicers "[n]otwithstanding any other provision of law, and notwithstanding any investment contract between a servicer and a securitization vehicle or investor."[93] After passage of H.R. 1106, investor lobbyists were able to point out the legislature's misunderstanding of the underlying securitization structure and how that misunderstanding could lead to an unconstitutional taking.[94] The safe harbor was modified in the Senate to give the investors limited opportunities to bring suit against servicers.[95]

Investor advocates have concluded that the Senate amended the original safe harbor provision to avoid criticism on Fifth Amendment grounds.[96] After comparing the two bills, it is clear that "the brazenness of the House bill may have made it easier to convince a court that outright abrogation of contract rights without just compensation violates the basic principles of the Constitution."[97] Some fear that the Takings Clause will no longer be able to aid the investors because the crafty language that Congress used in S.896.[98] On the other hand, considering the limited situations where an investor can enforce contract rights,

91. Press Release, H. Comm. on Fin. Serv., *supra* note 7.

92. Owen L. Cyrulnik, *The House and Senate Versions of Servicer Safe Harbor Compared*, ABS INVESTOR ADVOCATE, May 18, 2009, http://www.absinvestorad vocate.com/ (follow "Servicer Safe Harbor" hyperlink; then follow "The House and Senate Versions of Servicer Safe Harbor Compared" hyperlink) (last visited Jan. 20, 2010) [hereinafter Cyrulnik, *House and Senate Versions*].

93. *Id.* (quoting Helping Families Save Their Homes Act, H.R. 1106, 111th Cong. (2009)).

94. Gradman, *supra* note 12, at Part IV.

95. *See* Cyrulnik, *House and Senate Versions*, supra note 92.

96. *See id.*

97. *Id.*

98. *See id.*

the finalized provision seems to be as much a litigation shield as the House provision.[99] The statute clearly states that an investor can only bring suit if the lender was involved in predatory lending or engaged in fraudulent practices during origination.[100] Therefore Congress's attempts to lessen the harm done to investors were ineffective. Because investors are virtually powerless when seeking to enforce their contractual rights, many have suspected that the courts will agree that the safe harbor provision is unconstitutional.[101]

IV. ADVERSE CONSEQUENCES FROM THE SAFE HARBOR

The servicer litigation safe harbor, combined with other incentives for servicers, "would create opportunities for mortgage servicers to profit at the expense of investors who own the loans."[102] Not only would servicers be able to receive incentive payments for each modification, they would also be able to save themselves from "legal punishment."[103] In situations where the loan servicer is also the initial lender and entered into the mortgage agreement while engaged in unethical lending practices, the servicer-lender could modify the loan under Helping Families Save Their Homes, receive an incentive payment, and pass losses off to the investors.[104] There may also be instances of abuse when the servicer holds the second mortgage.[105] Four major banks service more than half of the mortgages in the United States.[106] Those banks are in the "perfect position" to make sure that the

99. *See generally* Owen Cyrulnik, *How* Safe, supra note 40. (discussing the Rule of Construction clause that only permits suit in instances of fraud, violation of state or federal law and predatory lending).

100. Helping Families Save Their Homes Act, Pub. L. No. 111-22, §201, 123 Stat. 1638 (2009) (codified as amended at 15 U.S.C. § 1639(a)).

101. Gradman, *supra* note 12, at Part V.

102. Gretchen Morgenson, *A Reality Check on Mortgage Modification*, N.Y. TIMES, Apr. 26, 2009, at BU1, *available at* http://www.nytimes.com/2009/04/26/business/26gret.html.

103. *Id.*

104. *Id.*

105. Eric Brenner & Hamish Hume, *How Big Banks Want to Game the Mortgage Mess*, WALL ST. J., May 4, 2009, at A15, *available at* http://online.wsj.com/article/SB124139532998281787.html.

106. *Id.*

mortgages are modified in a manner that benefits their second mortgages; a method that contravenes bankruptcy policy because second liens are supposed to be subordinate to primary liens.[107] If an investor in a first mortgage wanted to bring suit against a servicer because the servicer modified the loan in a way that only slightly benefitted the first mortgage but significantly benefitted the second mortgage, the investor would not be able to proceed because that suit would be based "solely" on the modification.[108]

Many investors feel as though they will not be able to protect themselves from self-interested servicers who hold subordinate loans.[109] Although investors seem powerless, one trust that specializes in MBSs is testing the strength of the safe harbor provision in court.[110] In *Greenwich Financial Services Distressed Mortgage Fund v. Countrywide Financial Corporation*, Greenwich Financial Services argued that one of the major flaws in the safe harbor; loan servicers can use the safe harbor to force others to pay for their mistakes.[111] As a part of a settlement for a predatory lending claim, Countrywide Financial agreed to modify at least 50,000 mortgage loans and bear roughly $8.4 billion of associated costs.[112] Fortunately for Countrywide, "most of these loans are owned not by Countrywide but rather by trusts to which Countrywide sold the loans in the process of securitization."[113] Greenwich Financial, a trust that owns loans scheduled to be modified, argued that its PSA prohibits Countrywide from modifying without re-purchasing the loans.[114]

Observers have commented that "if [the] Attorneys General were truly hoping to punish Countrywide for its

107. *Id.*

108. Owen Cyrulnik, *How* Safe, supra note 40.

109. Morgenson, *supra* note 102.

110. Complaint, *supra* note 12.

111. *Id.* at 2.

112. *Id.* at 3, 13.

113. *Id.* at *2.*

114. *Id.* at 12. Although the Act allows investors to sue servicers when the lender was involved with predatory lending under the Rule of Construction Clause, it is unclear whether the mortgages that are being modified resulted from predatory lending. One would assume that Greenwich's reliance on it's re-purchase provisions, and lack of reliance on the Rule of Construction Clause, that the modifications are not tied to the predatory lending.

irresponsible lending practices, foisting the cleanup costs on innocent investors was a remarkably ill-conceived way to do it."[115] Because the underlying issue of who will actually bear the costs has just come to the surface, the future value of the safe harbor provision is dependent on the decision in *Greenwich Financial v. Countrywide.*

V. ALTERNATIVES TO THE SAFE HARBOR PROVISION

Commentators and mortgage industry group have argued that the mortgage market will be negatively affected by the safe harbor provision.[116] Giving servicers the ability to act in a manner that breaches the duties set forth in PSAs without the possibility of recourse will "[undermine] the Obama administration's stated priority of fixing the housing market." *The Washington Times* Editorial Board stated that "if lenders can't stop the people they hire to manage mortgages from giving away their money, they won't lend any."[117] Grais & Ellsworth, the law firm representing Greenwich Financial, released a list of reasons why the safe harbor provisions "is bad for America."[118] Organizations like Greenwich Financial support the view that the safe harbor provision will "make mortgages harder to get" because the investors that provide money for the big banks to loan out will not give as much if most of the losses are shifted to them.[119] Fortunately, by not dismissing Greenwich's suit the court has shown that investors may be able to defend their contractual rights against servicers.[120]

Although the federal court did not rule on the applicability of the safe harbor provision, it did state that it will "allow people to enforce their contract rights when it is appropriate" by remanding the case to state court and requiring that Greenwich be able to prove that the PSA explicitly states that Countrywide must repurchase loans that it plans to modify.[121] Because it seems as

115. Gradman, *supra* note 12, at Part II.
116. Editorial, *supra* note 6.
117. *Id.*
118. Grais, *supra* note 78.
119. *Id.*
120. Morgenson, *supra* note 102.
121. *Id.*

though the safe harbor could be potentially more harmful to the housing market than foreclosures, many people have offered solutions to the problem; one of which seems practicable.

On the other side of the debate, Yale professors Mayer, Morrison, and Piskorski offered a policy solution to Congress in January of this year that contained three elements that would help turn around the housing market.[122] The plan would (1) provide monthly incentive fees to servicers who complete successful modifications, (2) payments to second lienholders equal to five percent of the outstanding second lien balance, and (3) a litigation safe harbor that "eliminates explicit limits on modifications" and compensates investors.[123] The proposal establishes a compensation scheme built into the modification plan itself. It requires that the modifications made "improve[ ] payments to investors as a group."[124] The proposal does not make clear how much benefit investors must receive but it implies that the investment return must be increased at least marginally.[125] While the Act contains many of the same elements that the professors proposed, the key factor that would make the safe harbor workable and constitutional is not present in the Act.[126] As the professors explain, their proposal would be constitutional "because investors are compensated."[127]

Others feel as though compartmentalization is the best way to turn around the housing market. Isaac Gradman, a San Francisco litigator who specializes in subprime mortgage-related litigation, suggests that the test of who should bear the losses should be ad hoc.[128] His plan requires reviewing each mortgage and placing them into three distinct categories; two of which result in foreclosure.[129] Those two categories are mortgages resulting from borrower fraud and mortgages that are at risk of default

122. Mayer et al., *supra* note 13, at 417-428.

123. *Id.*

124. *Id.* at 424.

125. *Id.*

126. Helping Families Save Their Homes Act, Pub. L. No. 111-22, §201, 123 Stat. 1638 (2009) (codified as amended 15 at U.S.C. § 1639a); *Id.*

127. Mayer et al., *supra* note 13, at 424.

128. Gradman, *supra* note 12, at Part VI.

129. *Id.*

because the borrower lost his job or had a significant illness in the family.[130] The last category contains mortgages that are a result of predatory lending practices and should, he claims, be modified at the lender's expense.[131] However, this solution does not stop second lienholders from taking advantage of their servicer status modifying the loan in a manner that benefits the subordinate lien more than the primary lien. This would cause the primary lienholder to have to bear all of the costs while receiving little of the benefit. While this would not harm the investors as much as the safe harbor, this system may open the door to a different takings claim. Also, this program would be extremely time-consuming. One of the major complaints that members of Congress have heard from their constituents is the length of time it takes for them to hear from someone about modification.[132] Requiring a servicer to review and categorize all loans would take an immense amount of time and would make the program difficult to implement. If one is waiting too long, their home may go into foreclosure before they have any information about their eligibility.[133]

A third, workable alternative has been proposed by Curtis Glovier, Managing Director of Fortress Investment Group, in his testimony before the Senate Banking, Housing and Urban Affairs Committee.[134] Glovier recommends refinancing rather than modifying the existing mortgage because modifications result in negative equity.[135]

Refinancings will not be considered a taking by the investors because the loans are set up in a manner that will allow them to succeed in the future and avoid the re-default that investors fear.[136] As Glovier states, the economy cannot turn around unless all interested parties are willing to take a small hit

130. *Id.*

131. *Id.*

132. *Glovier Testimony*, *supra* note 26.

133. *Preserving Homeownership: Progress Needed to Prevent Foreclosures: Hearing Before the S. Banking, Housing, & Urban Affairs Comm.*, 111th Cong. (2009).

134. *Glovier Testimony*, *supra* note 26, at 3-4.

135. *Id.* at 4.

136. *See id.*

because "solutions cannot be a windfall for certain stakeholders and terrible for others."[137]

VI. CONCLUSION

Unfortunately, the servicer litigation safe harbor provision is unjust and potentially unconstitutional.[138] The safe harbor provision grants servicers too much discretion and an opportunity to take advantage of the housing correction.[139] Because Congress drafted the bill without a clear understanding of the securitization structure,[140] it has potentially done more damage to the American housing market than foreclosures ever could.[141] If Congress wants to attain its goal of "fixing the housing market"[142] while continuing to have the financial support of investors,[143] it would be best to take investor and borrower interests into account and restructure the Hope for Homeowners refinancing system to address the problems of negative equity and re-defaults.[144]

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137. *Id.*
138. Mayer et al., *supra* note 13, at 424-25.
139. *See* Brenner, *supra* note 105.
140. *See* Heller, *supra* note 3.
141. *See* Grais, *supra* note 78.
142. Editorial, *supra* note 6.
143. *See id.*
144. *Glovier Testimony*, *supra* note 26, at 4.